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BEFORE THE INSURANCE COMMISSIONER

OF THE STATE OF CALIFORNIA

In the Matter of the Rate Applications of **ALLSTATE INSURANCE COMPANY and ALLSTATE INDEMNITY COMPANY,** Applicants.	)	File No. PA-2007-00004

PROPOSED DECISION

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INTRODUCTION

The statutes enacted pursuant to Proposition 103, an initiative supported by a majority of voters in 1988, establish the system for the prior approval of insurance rates.[1] Section 1861.05(a) provides:

> "No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income."

The requirement of prior approval of rates marked a significant change in California law. The declared purpose of Proposition 103 is "to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." (Historical and Statutory Notes, 42A West's Ann. Ins. Code (1993 ed.) §1861.01, p. 649. See also, *Calfarm Ins. Co.* v. *Deukmejian* (1989) 48 Cal.3d 805, 813.) As stated by the California Supreme Court: "Proposition 103 was intended to do away with the 'open competition' system. . . ." (*20th Century Ins. Co.* v. *Garamendi* (1994) 8 Cal.4th 216, 300.)

Proposition 103, therefore, charged the Insurance Commissioner with the responsibility of protecting consumers from arbitrary insurance rates and practices, and ensuring that insurance is fair, available and affordable within a competitive market. In 1991, the Insurance Commissioner adopted regulations to implement the ratemaking provision of Proposition 103 that are contained in Subchapter 4.8 of the California Code of Regulations, title 10, commencing with section 2641.1. These regulations include a

[1] Proposition 103 is codified at Insurance Code §1861.01, *et seq.* All references to sections are to the Insurance Code unless otherwise indicated.

regulatory formula for determining whether a rate is excessive or inadequate, which was upheld by the California Supreme Court in *20th Century, supra,* 8 Cal.4th at p. 243.[2] In explaining the application of the ratemaking formula, the court stated:

> For review of rates under the "prior approval" system, the Insurance Commissioner determines both the maximum and minimum permitted earned premium. That is because, as stated, the insurer is effectively free to set for itself whatever rate it chooses between the "excessive" and the inadequate." A rate is "excessive" if it is higher than the maximum permitted earned premium. (See Cal. Code Regs., tit. 10 §2644.1.) It is "inadequate" if it is lower than the minimum permitted earned premium. (See *ibid.*) The commissioner must approve a rate that (as relevant here) falls between the "excessive" and the "inadequate." (See *Ibid.*)

(*20th Century, supra*, 8 Cal.4th at pp. 253-254.)

The prior approval regulations provide that "No rate shall be approved or remain in effect that is above the maximum permitted earned premium, as defined in California Code of Regulations, title 10, section 2644.2..." (Cal. Code Regs., title 10, section 2644.1.) The maximum permitted earned premium is defined in California Code of Regulations, title 10, section 2644.2, by the following formula:

$$\frac{\textit{losses + defense and cost containment expenses - ancillary income} - \textit{fixed investment income}}{\textit{1.0} - \textit{efficiency standard} - \textit{profit factor} + \textit{variable investment income factor}}$$

The insurer has the burden of proving by a preponderance of the evidence "every fact necessary to show that its rate is not excessive, inadequate or unfairly discriminatory...." (Cal. Code Regs., title 10, section 2646.5.) The regulations further specify that, where the Commissioner finds that a proposed rate is excessive, the rate shall not be used, and the Commissioner "shall indicate the highest rate that would not be excessive, which the insurer may adopt by amendment to its application, or the

[2] An amended version of the prior approval regulatory formula became operative on April 3, 2007, while this proceeding was pending. As discussed below, the new version of the formula was applied in this proceeding, pursuant to California Code of Regulations, title 10, section 2643.1.

Commissioner shall reject the rate in its entirety." (Cal. Code Regs., title 10, section 2644.1.)

In this proceeding, Allstate Insurance Company and Allstate Indemnity Company ("Allstate") applied for a rate decrease of 7.1% for the policies in their automobile lines of insurance in California. The California Department of Insurance ("CDI"), through its Rate Enforcement Bureau, appeared as a party in this proceeding, contesting Allstate's rate request. The Foundation for Taxpayer and Consumer Rights ("FTCR"), a nonprofit, public interest corporation, filed a timely Petition for Hearing, contending that the rates proposed by Applicants are excessive in violation of Insurance Code section 1861.05, subdivision (a), and California Code of Regulations, title 10, section 2644.1, *et seq.* (FTCR Petition for Hearing and Petition to Intervene, p. 5.)

Prior to the evidentiary hearing, all parties agreed that the regulatory formula, without variance, requires an 18.1% decrease.[3] While the parties agreed on the rate that will result from current regulatory formula without any variance, Allstate also requested the following variances to the ratemaking formula, pursuant to California Code of Regulations, title 10, section 2644.27, subdivision (f)[4]:

1) Subdivision 2: recovery of additional costs for bona fide loss-prevention and reduction activities;

2) Subdivision 3(B): higher efficiency standard due to superior service to underserved communities;

3) Subdivision 4: higher return on equity due to higher investment in underserved communities;

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[3] By additional testimony of Allstate's Senior Actuary Steven D. Armstrong, submitted on November 21, 2007, and Exhibit 113, reflecting current financial data, Allstate acknowledged that the regulatory formula, without variance, requires a 19.4% decrease. Neither CDI nor FTCR sought to cross-examine Mr. Armstrong on this point, and FTCR has expressly concurred with this figure. (FTCR Post-Hearing Opening Brief, 1:17-20.)

[4] At the outset of the evidentiary hearing in this case, Allstate announced that it had withdrawn its Variance request pursuant to subdivision (3)(A). (Reporter's Transcript Nov. 5-7, 2007 ("RT") 13:13-22.)

4) Subdivision 10: modified trend formula due to change in mix of business; and

5) Subdivision 11: "constitutional" or "confiscatory" variance.[5]

The parties filed written direct testimony pursuant to California Code of Regulations, title 10, section 2655.6. An evidentiary hearing was held before Administrative Law Judge Christopher R. Inama ("ALJ") on November 5 through November 7, 2007, during which parties had the opportunity to present additional oral direct testimony from their witnesses and cross-examine opposing witnesses. In addition to written and oral testimony by witnesses, Allstate, CDI, and FTCR presented more than 100 documents as exhibits.

Following the evidentiary hearing, the parties filed post-hearing briefs pursuant to California Code of Regulations, title 10, section 2657.1.

SUMMARY OF FINDINGS

After careful consideration of the evidence and arguments presented by the parties in this proceeding, the ALJ finds that Allstate's proposed rate decrease of 7.1% will result in an excessive rate. In particular, Applicants failed to prove by a preponderance of the evidence that the variances they requested for additional costs for bona fide loss-prevention and reduction activities (Variance Request No. 2), modified trend formula due to change in mix of business (Variance Request No. 10), and the "constitutional" or "confiscatory" variance (Variance Request No. 11) in the rate application are reasonable. The ALJ further finds that this record would support a rate indication of no more than

[5] By their stipulation, filed November 7, 2007, the parties agreed that Allstate reserved its right to argue for Variance No. 11 on appeal, that all parties would withdraw their testimony relating to Variance No. 11, and none would offer any additional evidence relating to Variance No. 11.

-15.9%, based on an increase of 1% to the efficiency standard (Variance No. 3(B)) and a 2% increase to the rate of return (Variance No. 4), and based on the reasons discussed more fully below.[6]

PROCEDURAL HISTORY

On October 6, 2006, Allstate filed rate applications with the CDI, File Nos. 06-06-7438 and 06-7439.[7] On January 5, 2007, CDI filed a Notice of Hearing. On January 19, 2007, Allstate filed its Notice of Defense. On January 25, 2007, Allstate filed an Amended Notice of Defense. On the same date, Chief ALJ Marjorie A. Rasmussen issued a Notice of Scheduling Conference and ordered FTCR to file its Petition to Intervene in this matter, which FTCR filed on February 6, 2007.

During a scheduling conference on February 14, 2007, Chief ALJ Rasmussen granted FTCR's Petition to Intervene. The parties disclosed that a dispute had arisen over which version of the regulatory regulations should govern these proceedings, and the Chief ALJ ordered the parties to file briefs on the issue.[8] Following oral argument, on April 10, 2007, Chief ALJ Rasmussen ordered, "The amended version of the ratemaking regulations contained in California Code of Regulations, title 10, commencing with section 2642.1 (operative on April 3, 2007) shall apply to these proceedings."[9]

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[6] Exhibit 113.

[7] Notice of Hearing; Allstate's Verified Answer to the Petition for Hearing; Allstate's Amended Brief, p. 2; FTCR's Opening Brief, p. 7. The applications themselves are not part of the record in this proceeding.

[8] March 5, 2007, Order Following Scheduling Conference of February 14, 2007.

[9] Tentative Rulings on the Issue of the Applicable Regulations to be Applied in this Matter, filed April 9, 2007, pp. 6-7, and Final Ruling and Order on the Issue of the Applicable Regulations to be Applied in this Matter, filed April 16, 2007. See *In the Matter of the Rate Application of American Health Indemnity Co. and SCIPE Indemnity Co.*, DOI File PA-02025379, p. 8 ("[S]ince the question before the ALJ in a prior approval hearing is whether the evidence the applicant/insurer submits is reliable when used in the regulatory formula, it does not matter if the insurer initially used other methods or data to support the rate request on it rate application submitted to the CDI's rate filing bureau.")

Another scheduling conference was held on April 26, 2007, and the ALJ set dates for filing direct written testimony, motions to strike testimony, designation of witnesses, joint exhibit list, pre-hearing briefs, and commencement of evidentiary hearings.

On July 13, 2007, Allstate lodged the written direct testimony of Steven D. Armstrong, Prof. J. David Cummins, Dee Even, Robin Haworth, Annette Heying, Francisco Llende, Michael J. Miller, and Robert Sanders, with exhibits attached to the testimony of the sponsoring witnesses. On July 31, 2007, Allstate lodged the written direct testimony of Prof. Robert S. Hamada. CDI and FTCR filed timely motions to strike portions of the direct testimony of each of Allstate's witnesses. Following the hearing on the motions, the ALJ issued orders on August 7, 2007, granting in part and denying in part the motions to strike. Notably, the ALJ's order found that much of Allstate's testimony in support of Variance Request No. 11, the so-called "constitutional" or "confiscatory" variance under California Code of Regulations, title 10, section 2644.27, subdivision (f)(11), was not clearly relevant but might become relevant upon some showing that the maximum allowable rate would be confiscatory; in the alternative, that testimony might have been stricken at that point on the ground that it violated the bar against relitigation of the Insurance Commissioner's regulations and generic determinations. (Cal. Code of Regs, tit. 10, §2646, subd. (e).)[10] To give Allstate an opportunity to make a complete record as to Variance Request No. 11, the ALJ's August 7, 2007, order granted Allstate an extraordinary opportunity to file additional testimony to make a mere *prima facie* showing that the rate imposed would be confiscatory.[11]

CDI did not file any written direct testimony in this case.

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[10] Orders on Motions by CDI and FTCR to Strike Portions of Allstate's Testimony, filed Aug. 7, 2007, pp. 9-12.

[11] *Id*, pp. 6, 17-18.

On August 14, 2007, FTCR lodged the written direct testimony of its only witness, Allan J. Schwartz. Allstate filed a timely motion to strike portions of Mr. Schwartz's direct testimony. After briefing and argument, the ALJ issued orders granting in part and denying in part the motion to strike portions of Mr. Schwartz's testimony. The ALJ conditionally denied the motion to strike other portions of Mr. Schwartz's testimony, subject to a renewed motion by Allstate to strike, following *voir dire* at the evidentiary hearing on the witness's qualifications.

On August 24, 2007, Allstate lodged supplemental testimony by Mr. Armstrong and Mr. Haworth, pursuant to the August 7, 2007, order. CDI and FTCR filed timely motions to strike the supplemental testimony of Allstate's witnesses. Following the hearing on the motions, the ALJ issued orders on September 19, 2007, granting the motions to strike on the ground that Allstate's supplemental testimony was irrelevant and relitigation. (Cal. Code of Regs., tit. 10, §2646.4, subd. (e); *20th Century Ins. Co.* v. *Garamendi*, *supra*, 8 Cal.4th at p. 312.)[12]

On August 31, 2007, Allstate filed a Motion for Clarification of the Scope of the Relitigation Ban and for Leave to Fully Brief the Issue of Evidence Necessary to Prove a Confiscatory Rate. Allstate claimed that, in spite of the California Supreme Court's decision in *20th Century Ins. Co.* v. *Garamendi*, *supra*, Allstate was confused as to how to prove its allegation that the rate to be imposed would be confiscatory. The ALJ denied Allstate's motion without hearing on the grounds that the issues already had been determined by the U.S. and California Supreme Courts, and that Allstate still had an

[12] Final Ruling, filed September 19, 2007, pp. 6-7

opportunity to fully brief the issues, yet again, in response to CDI's and FTCR's pending motions to strike Allstate's supplemental testimony.[13]

On October 12, 2007, Allstate followed up with a Motion for Order Certifying Questions to the Commissioner, requesting certification of the following questions:

1) What is the legal standard that an insurer should be required to satisfy to demonstrate that an insurance rate prescribed under the Ratemaking Formula is confiscatory, and what is the "enterprise" to which the standard is to be applied?

2) Does the so-called "relitigation bar" set forth in California Code of Regulations, title 10, section 2646.4, subdivision (c), prevent an insurer from proving that the rate produced by the Ratemaking Formula without variance is confiscatory by showing that the insurer's operating costs would be less than the rate produced by the Ratemaking Formula, without grant of any variances?

3) Is there a "*prima facie*" case standard that the Court may apply after submission of written direct testimony to evaluate the sufficiency of an applicant's case for grant of variance under Variance 11?

Allstate did not present any facts in support of the motion, and none of the cases cited by Allstate in written argument were apposite.[14] Therefore, the ALJ determined that requiring CDI and FTCR to respond to the motion would impose unreasonable and unnecessary costs of time and resources on them and denied Allstate's motion without setting it for hearing.[15]

Evidentiary hearings commenced on November 5 and continued through 7, 2007. Pursuant to California Code of Regulations, title 10, section 2655.8, all parties were permitted to present additional direct testimony, and all parties had an opportunity to cross-examine opposing witnesses. In this proceeding, Allstate presented the following witnesses in support of their rate application:

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[13] Order Consolidating Motions for Hearing and Request for Hearing on Motion for Clarification, filed Sept. 4, 2007, pp. 2-3.
[14] Reporter's Transcript, Oct. 16, 2007, pp. 53-61.
[15] Order Denying Allstate's Motion for Order Certifying Questions to Insurance Commissioner, filed October 23, 2007, pp. 2-6.

- Steven Douglas Armstrong, an actuary employed by Allstate, whose responsibility involves oversight of all actuarial and ratemaking work performed in connection with private passenger automobile and homeowners' insurance within Allstate's "Western Territory," including the State of California. Mr. Armstrong oversaw the preparation of the rate application and testified regarding how Allstate derived the values in the filing and in support of all of Allstate's variance requests.
- Michael J. Miller, a consulting actuary employed by EPIC Consulting, LLC, testified regarding Allstate's compliance with generally accepted actuarial practices and principles and rate standards in the California statutes and regulations, as well as his actuarial opinion on the reasonableness of the rates requested in Allstate's amended application.
- Dee Even, Senior Managing Director in Allstate's Investment Department, was responsible for management of $8.7 billion in equity assets. She testified regarding Allstate's investment in underserved communities, in support of Variance Request No. 4.
- Francisco Miguel Llende, employed as Allstate' Special Investigations Manager for the PacWest Special Investigation Unit ("SIU"), testified regarding the operation of, cost of, and loss recoveries by Allstate's SIU, in support of Variance Request No. 2.
- In addition, Allstate filed written direct testimony by several witnesses who were not present at the evidentiary hearing and not made available for cross-examination: Prof. J. David Cummins, Prof. Robert S. Hamada, and Robin Haworth provided written direct testimony in support of Variance Request No. 11, all of which was essentially stricken; and Annette Heying and Robert Sanders, whose testimony in support of

Variance Request No. 3(A) was made irrelevant by Allstate's withdrawal of that variance request.

CDI did not present any witness of its own in this proceeding, although CDI examined the other parties' witnesses and submitted post-hearing briefs.

FTCR presented one witness, Mr. Allan I. Schwartz, a consulting actuary and principal in AIS Risk Consultants, in support of FTCR's contention that a rate reflecting any of Allstate's requested variances would result in an excessive premium.

The parties filed post-hearing opening briefs on December 21, 2007 and reply briefs on January 15, 2008.

DISPUTED ISSUES

All parties agree that the regulatory formula, without variance, requires a 19.4% rate decrease. Therefore, the issues remaining to be determined are Allstate's qualification for and the amount of the following variances to the ratemaking formula, requested by Allstate pursuant to California Code of Regulations, title 10, section 2644.27, subdivision (f):

1) Variance No. 2: recovery of additional costs for bona fide loss-prevention and loss-reduction activities;

2) Variance No. 3(B): higher efficiency standard due to superior service to underserved communities;

3) Variance No. 4: higher return on equity due to higher investment in underserved communities;

4) Variance No. 10: modified trend formula due to change in mix of business; and

5) Variance No. 11: "constitutional" or "confiscatory" variance.[16]

[16] By Stipulation and Order, filed November 7, 2007, Allstate reserved its right to argue for Variance No. 11 on appeal, and the parties agreed to withdraw all of their testimony relating to Variance No. 11 and to refrain from offering any additional evidence relating to it. Since Allstate has indicated that it is requesting the Commissioner to review the ALJ's interim rulings striking Allstate's evidence in support of this

ANALYSIS OF THE DISPUTED ISSUES

I. CDI's Withdrawal of Objections to Some of Allstate's Variance Requests Does Not Resolve Those Issues.

Following the evidentiary hearing, CDI withdrew its objections to Allstate's Variance Requests Nos. 3(B) and 10, as well as its objection to Allstate's qualification for Variance No. 4 (although CDI continues to dispute the amount to be awarded for this variance). CDI continues to dispute Allstate's Variance Request No. 2, and FTCR disputes all of Allstate's variance requests.

Based on CDI's withdrawal of some of its objections, Allstate contends that those issues should be deemed resolved, and FTCR, as Intervenor, should not be "permitted to prevent that resolution by offering its own views on the issue" or to "substitute its judgment for that of the CDI."[17] Allstate cites no California authority in support of its contention, and the Florida appellate court decisions cited by Allstate are inapposite.

In *Envtl. Confederation of Southwest Fla., Inc.* v. *Dep't of Envtl. Prot.* (1986) 886 So.2d 1013, 1017-1018, the original enactment of section 403.412, Florida Statutes, gave citizens of the state substantive rights to challenge certain environmental permits, but changes to the statute eliminated third parties' previous right to initiate a proceeding upon notice of the agency's intent to issue a permit. Essentially a class of people no longer had a statutory right where one existed before.

In *Humana of Fla., Inc.* v. *Department of Health & Rehabilitative Servs.* (1986) 500 So.2d 186, 187-188, an intervenor contended that, having properly joined in the administrative proceeding, it could not be divested of its rights as a party by the

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variance request, the basis for the ALJ's rulings on the evidence proffered by Allstate in support of Variance Request No. 11 is fully discussed below.,

[17] Allstate Reply Brief, pp. 1-2.

petitioner's voluntary dismissal of the hearing. The petitioner, a private party, had initiated the proceeding and then filed a notice of voluntary dismissal of its petition for formal hearing. The agency entered an order, concluding that the petitioner had an absolute right to dismiss its action, and the exercise of that right terminated the proceeding. On appeal by the intervenor, the court held that, since the petition was withdrawn, agency jurisdiction ceased to exist. Thus, since the intervenor joined the proceeding subject to the action of the original petitioner, there was no longer any valid proceeding in which the intervenor could participate.

Unlike the situations in Allstate's Florida cases, it is clearly established in California that a third party has a right to initiate or intervene in an administrative proceeding to challenge an action of the Insurance Commissioner or enforce the provisions of the statutes enacted pursuant to Proposition 103. (Govt. Code § 11440.50; Ins. Code § 1861.10, subds. (a) and (b); Calif. Code of Regs, tit. 10, § 2661.1, *et seq*; see *Farmers Ins. Exchange* v. *Superior Court* (2006) 137 Cal.App.4th 842, 853-854.) Thus, FTCR may continue to contest Allstate's rate application even where CDI does not oppose the application.

Further, it cannot be determined from CDI's statements in its post-hearing briefs whether the unexplained withdrawal of some of CDI's previous objections is based on the application of its administrative expertise or is simply due to exigencies of the litigation. (See *Farmers Ins. Exchange* v. *Superior Court*, *supra*, at p. 859 ["Factors indicating that an agency's interpretation is likely to be correct include careful consideration by senior agency officials, consistency in maintaining the interpretation, adoption of the interpretation contemporaneously with the legislative enactment of the

statute in question, and adoption of a formal interpretive rule under the Administrative Procedures Act (Gov. Code, § 11340 et seq.). [citation omitted] An agency's *ad hoc* assertion of a statutory interpretation in a particular matter or in the course of litigation, on the other hand, does not engender the same degree of respect."]; see also *Price* v. *Atchison, T. & S. F. R. Co.* (1958) 164 Cal.App.2d 400, 404-405 ["Evidence of a compromise settlement by the defendant of a claim which originated in the very tort alleged by the plaintiff is inherently harmful in the trial of an action for personal injuries. It invades the province of reason in the exercise of its function to ascertain the truth.... Where the culpability of a defendant in an action based upon his alleged negligence is in issue it should be the aim of the court to endeavor to derive a determination of factual liability by competent proof of the circumstances and occurrences constituting the transaction alleged, and it should not be guided by compromise settlements which the defendant has made of other claims arising out of the same facts."].)

Therefore, CDI's withdrawal of its objections to some of Allstate's variance requests does not resolve those issues. FTCR may continue to challenge Allstate's Variance Requests Nos. 3(B), 4, and 10.

II. Burden of Proof.

It is not disputed that Allstate has the burden of proving by a preponderance of evidence every fact necessary to demonstrate that it qualifies for each variance from the regulatory formula it has requested. (Ins. Code §1861.05, subd. (b); Cal. Code of Regs, tit. 10, §2646.54; see *Price* v. *Atchison, T. & S. F. R. Co.*, *supra*, 164 Cal.App.2d 400, 406 [The evidence and inferences therefrom must have greater weight and more

convincing force in the mind of the trier of fact than the explanation and evidence offered by the opposing parties.].)

III. Determination of Amount or Degree of Variances.

Allstate has made five variance requests pursuant to California Code of Regulations, title 10, section 2644.27, subdivision (f). As to Variance Request Nos. 3(B) and 4, discussed below, the Commissioner has not selected generic determinations of the amount or magnitude to be awarded for each variance. Where, as in the instant proceeding, the pertinent regulation does not prescribe the amount or degree of a variance, the ALJ must adopt a reasonable variance amount, based on actuarial principles and expert judgment. (See the precedential decision, *In the Matter of the Rate Application of American Health Indemnity Co. and SCIPE Indemnity Co.*, DOI File PA-02025379, p. 9 ["This, of course, is not the only instance that the Insurance Commissioner has left a matter open for case-by-case determination. In a number of instances, the Prior Approval Regulations call for the adoption of generic factors by the Commissioner. Since the Insurance Commissioner has not adopted these generic factors, values may be selected "using generally accepted actuarial principles, expert judgment and standards of reasonableness."]; *Jurcoane v. Superior Court* (2001) 93 Cal.App.4th 886, 894; *20th Century, supra*, 8 Cal. 4th at p. 312. .)

IV. Allstate Does Not Qualify for Variance No. 2 (Recovery of Additional Costs for Bona Fide Loss-Prevention and Loss-Reduction Activities).

A. <u>Applicable Laws</u>.

California Code of Regulations, title 10, section 2644.27, subdivision (f)(2), provides:

> The following are the valid bases for requesting a variance: ¶(2) That the insurer should be allowed to recover additional costs for bona fide loss-prevention and loss-reduction activities, provided the insurer can demonstrate loss reductions commensurate with the increased expenditures.

The parties disagree as to the meaning of "additional costs" in the variance. Allstate contends that the term does not mean "costs above the industry average," "costs above the minimum compliance with the statutory SIU requirement," or "costs above the applicant insurer's previous costs," and concludes that "additional costs" means any costs in excess of the costs of its "non-loss prevention" business. That is, all of Allstate's loss-prevention costs should be included, including the easily identifiable costs of its Special Investigations Unit ("SIU"), which processes, investigates, and litigates insurance claims suspected of involving fraud.[18] For example, Mr. Armstrong testified that "'additional costs' has to refer to the costs associated with having a program compared to having no program at all."[19]

FTCR replies that the variance does not provide for recovery of "all" the insurer's costs for loss-prevention and loss reduction, but only for recovery of "additional costs" and "increased expenditures."[20]

CDI did not present any witness to testify regarding Allstate's Variance Request No. 2. However, in its post-hearing briefs, CDI joins in FTCR's criticism of Allstate's interpretation of "additional costs."[21]

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[18] Allstate Post-Hearing Brief 7:11-17, 8:22, 9-11; Llende Prefiled 2:14-15; RT 125:14-22. [As used in this proposed decision, "*Surname* Prefiled," followed by page:line number indicates pre-filed written direct testimony of the witness, pursuant to Cal. Code of Regs., tit. 10, §2655.6, as redacted according to ALJ rulings on motions to strike.]

[19] RT 26:5-13, 30:11-15. Mr. Miller stated it somewhat differently: "[I]t would be the loss reduction and loss prevention expenses associated with an SIU, which are in addition to the loss reduction and loss prevention activities that an insurer has outside the SIU function as part of their regular claims adjustment process." (RT 125:17-22.)

[20] FTCR Post-Hearing Opening Brief 8-11; RT 145:5-17, 460:4-23, 462:8-465:23.

[21] CDI Post-Hearing Opening Brief 3-4.

As used in Variance No. 2, the term "additional costs" refers to those costs above mere compliance with the statutory SIU requirement. Insurance Code section 1875.20, and California Code of Regulations, title 10, section 2698.31, mandate that insurers bear the costs of establishing and operating SIUs. Further, the costs associated with an SIU are accounted for in the regulatory formula: allocated SIU costs are already reflected, dollar-for-dollar, in "projected defense and cost-containment expenses" (Cal. Code of Regs., tit. 10, § 2644.8), and unallocated SIU costs are already built into the efficiency standard. Therefore, to qualify for this variance, the ALJ determines that an insurer must demonstrate that it incurs costs in excess of merely establishing and operating its SIU, such as expenditures for extraordinary SIU operations or novel loss-prevention/loss-reduction activities, and those additional expenditures must lead to commensurate loss reductions. Allstate's evidence does not demonstrate that it has incurred such additional costs or realized commensurate reductions.

B. Evidence on Variance No. 2.

Mr. Llende testified that Allstate has committed resources to combating fraud and makes "hard loss recoveries" (monetary recoveries) and "soft loss recoveries" (fraudulent claims prevented).[22] However, Mr. Llende did not quantify SIU expenses over and above what was required to comply with the statute and regulation;[23] did not audit the expense numbers for accuracy;[24] and could not testify that expenditures for independent adjusters, legal expenses, medical costs private investigators, arbitrations, coverage opinions and examinations under oath, or non-medical experts were for *bona fide* loss-prevention or

[22] Llende Prefiled 19:8-20; RT 259-267.
[23] RT 353:8-23.
[24] RT 320:3-13.

reduction.[25] Mr. Armstrong deferred entirely to Mr. Llende on this variance request.[26] Mr. Miller could not compare Allstate's efforts with the industry or any competitor.[27]

In response, Mr. Schwartz testified that Allstate did not show additional costs and increased expenditures in excess of maintaining the SIU, that the SIU costs are already included in components of the ratemaking formula, and that Allstate did not demonstrate loss reductions commensurate with increased expenses.[28]

C. **Conclusion.**

Based on the evidence, the ALJ concludes that Allstate has not demonstrated that it has incurred any "additional costs" or made any "increased expenditures." Although the evidence indicates that Allstate has realized significant "hard" and "soft" loss recoveries,[29] in the absence of evidence that Allstate has incurred quantifiable "additional costs," it cannot be determined that Allstate's benefits are commensurate with its increased expenditures. Moreover, Allstate's witnesses did not demonstrate that Allstate has committed new resources to the effort, compared to expenditures during some previous period of time. For these reasons, Allstate has not satisfied its burden of proof in support of its Variance Request No. 2.

V. Allstate Qualifies for Variance No. 3(B) (Higher Efficiency Standard Due to Superior Service to Underserved Communities).

A. **Applicable Laws.**

California Code of Regulations, title 10, section 2644.27, subd. (f)(3)(B), provides:

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[25] RT 309:3-12, 312:17-313:4, 314:7-13, 316:5-13, 322:5-323:15, 323:3-324:6, and .327:7-18.
[26] RT 72:17-73:4.
[27] RT 126: 2-22.
[28] Schwartz Prefiled 11-16.
[29] RT 262:14-20, 263:12-264:1, 266:18-267:6, 273:19-274:7, 275:2-10.

> The following are the valid bases for requesting a variance: ¶(3) That the insurer should be allowed a higher or lower efficiency standard due to: ¶(B) demonstrably superior or inferior service to underserved communities, as defined in section 2646.6."

The parties disagree on the meaning of the phrase, "service to underserved communities." Allstate contends that service to underserved communities means "market share" or "presence" in such communities, not "quality of service."[30] Based on this interpretation, Allstate contends that its market share in California's underserved communities is demonstrably superior, quantitatively, to the market share of Allstate's competitors.[31]

CDI did not present any evidence relating to Allstate's Variance Request No. 3(B). In its Post-Hearing Opening Brief, CDI withdrew its objection to Allstate's variance request.[32]

FTCR opposes Allstate's Variance Request No. 3(B), contending that the variance requires qualitatively superior service, not just quantitatively superior service.[33] "Service," according to FTCR, must be assessed according to its quality. FTCR notes that "service," according to California Code of Regulations, title 10, section 2646.6, subdivision (b)(2), "means claims service and sales service."[34] However, that regulatory definition, by itself, says nothing about quality or quantity, and FTCR fails to mention that the context provided by the opening and closing sentences of subdivision (b)(2) indicates that the regulation's definition of "service" is quantitative: "[T]he Community Service Statement shall contain the *number* of service offices maintained in the Zip Code

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[30] Allstate Post-Hearing Brief 16:11-17:23; Miller Pre-filed 2:10-18; RT 129:6-12.
[31] Allstate Post-Hearing Brief 17:25-18:18; RT 81:17-22, 127"6-19, 129:6-12, 551:6-552:3.
[32] CDI Post-Hearing Opening Brief 1:26-27.
[33] FTCR Post-Hearing Opening Brief 17:17-18:12, 22:21-23:2.
[34] FTCR Post-Hearing Opening Brief 17:14-18:3; 22:21-23:2.

during the reporting period.... Where *more than one service* is performed at an office the insurer shall categorize the office based upon the service [*sic*] or services performed at that office." (emphasis added.)

Next, FTCR contends that Allstate's interpretation ignores the very rules of statutory interpretation on which Allstate purports to rely. In support of that contention, FTCR argues that, if the Commissioner intended for Variance No. 3(B) to be based on "market share," the Commissioner would have adopted a regulation that stated as much.[35] Yet, FTCR overlooks the fact that the Commissioner has adopted a variance expressly based on "quality" of service. California Code of Regulations, title 10, section 2644.27, subd. (f)(3)(A), specifically provides for a variance where there is a showing of "higher or lower *quality* of service, as demonstrated by objective measures of *customer satisfaction*." (emphasis added.) Thus, where Variance No. 3(A) is based on "quality of service" and "customer satisfaction," and these same considerations are omitted from Variance No. 3(B), it can only be inferred that Variance No. 3(B) is not based on quality of service. (See *Bernard* v. *Foley* (2006) 39 Cal.4th 794, 811 ["The Legislature's failure to include an express friendship exception within the statutory scheme is significant, because the Legislature knows how to craft such an exception when it wishes to do so. The Legislature has expressly promulgated a friendship exception in another context..."]; *Gikas* v. *Zolin* (1993) 6 Cal.4th 841, 852 ["*Expressio unius est exclusio alterius*. The expression of some things in a statute necessarily means the exclusion of other things not expressed."].)

For these reasons, the ALJ determines that "service to underserved communities" means service in its quantitative sense.

[35] FTCR Post-Hearing Reply Brief 13:3-17.

In addition to its dispute regarding the interpretation of "service," FTCR argues that, even if the number of a carrier's exposures is used to determine superior service, Allstate's figures should not be used; instead, the percentages listed in the Commissioner's Report should be used.[36] Further, FTCR contends that the amount of Allstate's variance request is excessive.[37] Finally, FTCR complains that this variance will result in additional premiums in the sum of $20 million per year.[38] The ALJ determines that the variance is intended solely to result in a modification of the efficiency standard, and no "end result" test applies in Variance No. 3(B). The end result test only applies, by its terms, in Variance Request No. 11, the so-called "constitutional" or "confiscation" variance. Cal. Code of Regs., tit. 10, §2644.27, subd. (f)(11).)

B. Evidence on Variance No. 3(B).

Mr. Armstrong testified that the average market share in underserved communities is 1%, while Allstate's market share in underserved communities is 9%.[39] The share of Allstate's total automobile insurance business that it sells in underserved communities is significantly higher than the industry average: approximately 8.7% of all industry exposures are sold in underserved communities, while Allstate sells approximately 9.4% of its total exposures in underserved communities.[40] By statistical analysis of the ten largest automobile insurance carriers in California, Allstate's 15.5% market share in underserved communities is approximately one standard deviation above the 10% mean of the market share of the ten largest carriers. [41] Only one other large

[36] FTCR Post-Hearing Opening Brief 20:9-22:2; Exhibits 14:25-32, 439:25
[37] FTCR Post-Hearing Opening Brief 23:3-25.
[38] FTCR Post-Hearing Opening Brief 2:7-12.
[39] RT 36:11-19, 37:25-39:4; 105: 20-22; Exhibits 99 and 108.
[40] Armstrong Prefiled 33:10-15, Exhibits 14 and 99.
[41] Armstrong Prefiled 34:18-20, 35:14-18; Miller Prefiled 22:22-26, 30:10-11; RT 32:7-18, 43:4-18, 83:19-84:9, 119:10-16. Even the FTCR's witness, Mr. Schwartz acknowledges that, statistically, Allstate's market

carrier has a higher percentage of its agents located in underserved communities.[42] Since the regulation does not provide any parameters, in his actuarial judgment, Mr. Armstrong concluded that Allstate is entitled to an additional 1% above the efficiency standard prescribed by the prior approval regulations[43]

Mr. Schwartz's testimony in response to Mr. Armstrong and Mr. Miller is not persuasive. For example, Mr. Schwartz' did not give consistent and straightforward answers relating to the question of Allstate's "market share" and qualification for Variance No. 3(B). In his prefiled, written direct testimony, Mr. Schwartz defined "market share" as an arithmetic calculation of the "amount of business written by a particular insurer in relation to the total amount of that business written by all insurers."[44] This definition is consistent with the commonly accepted definition of "market share" in the fields of economics and law.[45] However, on cross-examination, Mr. Schwartz reneged on that definition and adopted another one, stating that there are multiple definitions of

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share in underserved communities is superior to slightly more than 80% of the ten largest carriers. (See FTCR Post-Hearing Reply Brief 15:17-16:3 and RT 565:3-566:7.)

[42] Armstrong Prefiled 34:1-11; Exhibits 14 and 16.

[43] Armstrong Prefiled 35:16-23; RT 32:7-18, 83:19-86:1.

[44] Schwartz Prefiled 30:3-7; RT 544:6-17.

[45] See Bannock, *et al*, The Penguin Dictionary of Economics (5th ed., 1992) p. 275: "MARKET SHARE. This can refer to (a) the sales of the product or products of a firm as a proportion of the sales of the product or products of the industry as a whole.... Or to (b) the sales of a particular *commodity* compared with the total sales for the class of commodity of which the particular commodity is a member..." See also *Western Union Fin. Servs.* v. *First Data Corp.* (1993) 20 Cal.App.4th 1530, 1533, 1541; *United States* v. *Aluminum Co. of Am.* (2d Cir 1945) 148 F2d 416, 424 [Market power is most often defined by market share, which is calculated by dividing the antitrust defendant's sales by the sales of the total market.]; Kintner, *et al.*, Federal Antitrust Law: Economic Theory, Common Law, and an Introduction to the Sherman Act, § 14.4 ["Market share is the most frequently used proxy for monopoly power. [footnote omitted] It is relevant to the issue because a firm with a larger share of the market can affect the market's output by a relatively smaller percentage reduction of its own output. [footnote omitted] Obviously, a firm controlling the entire market can reduce the market's output by 5 percent (at least initially) by reducing its own output 5 percent; but a firm controlling only half of the market will be able to reduce the market output by 5 percent only by reducing its own output by 10 percent. Thus, the firm with a lower market share (other things equal) will need to reduce output by a higher percentage in order to obtain a given percentage increase in price."]

"market share."[46] Mr. Schwartz stated his new definition of "market share" as "the relationship between one segment of business in relation to a larger segment of business."[47] Based on his testimony, it appears that Mr. Schwartz may be confused about or, even, ignorant of the fundamental distinction between "markets" and "firms."[48]

Mr. Schwartz's confused parsing and multiple definitions of "market share" led him to articulate an unfathomable critique of Allstate's Variance Request No. 3(B).[49] As

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[46] RT 545-548; also see RT 558:18-23: Q. When we talk about company's market share, doesn't the respective market share of each of the participants in a particular market usually add up to 100 percent?

A. It depends how you do the calculation. I mean, again, it depends how you define "participants."

[47] RT 548-549.

[48] See R.H. Coase [1991 Nobel Prize in Economics], The Firm, the Market, and the Law (1988); RT 561:21-562:12: ALJ INAMA: Can I get some clarification? Are you saying that intra, internal to Allstate, is a market?

A. Yes, I believe you can calculate it that way in terms of saying that of Allstate's total market, you know, how much they are in various segments, and that's something insurance companies, you know, look at all the time, is what classes of business they're going to write, and, you know, targets for what classes of business they're going to write. ¶So, they spread their business around in different categories. It could be by classification factor, you know, by type of use of the car or mileage or territory, but companies normally break down their statewide total business of everything they write into percentages by categories, so they would see how much business they're writing in every category.

[49] RT 549:22-552:3: "Q. You're suggesting that this so-called specialized definition of market share that you gave in your prefiled direct testimony is the less common definition of "market share"?

A. I don't know how to determine what's common and what's not common. I know market share is defined—well, people do calculations of market share on different bases, and, you know, I should have in my testimony made it clear that really the calculation of market share is a more general calculation as opposed to the restrictive calculation that I set forth.

Q. The fact is, Mr. Schwartz, Allstate does not have 9 percent share of the private passenger automobile business the California underserved community, correct?

A. Could I have that read back?

(record read)

Q. 9.4 percent.

A. Depends what Allstate's share in the underserved community is related to. If Allstate's exposures in the underserved community are related to Allstate's statewide exposure, you know, that number is 9.4 percent. If Allstate's exposure in the underserved communities is related to a different bases of the exposures in underserved communities for all insurance companies, the arithmetic turns out to be 9. I mean, they're both market share numbers. They're just relating that the initial subset of information, the Allstate exposures and underserved communities, to two different bases....

Q. And the fact is, that puts Allstate at Number 3 on the list, correct? "Yes" or "No"?

A. Well, they're the third highest value under that definition.

Q. And the fact is that there aren't 37 companies that write a higher number or higher percentage of business in that community, correct? ....

A. Based on that column that you're pointing to, there are not 35 companies with higher values than Allstate.

Q. And that particular column that I'm referring to is a column the numbers of which were computed according to the formula and definition that you gave in your direct testimony, correct?

A. Yes.

discussed above, Mr. Armstrong and Mr. Miller offered testimony that Allstate provided superior service to underserved communities in four ways (ratio of exposures sold in underserved communities to total exposures; market share; statistical comparison of the ten largest companies; and percentage of agents located in underserved communities). In his prefiled direct testimony and live testimony, Mr. Schwartz did not address these points separately. Instead, Mr. Schwartz conflated the first two methods by which Allstate demonstrated quantitatively superior service to underserved communities. Where Allstate compared its ratio of exposures in underserved communities against its total exposures to the industry ratio, Mr. Schwartz improperly characterized those ratios as "market share" and claimed that 35 insurers have a greater market share.[50] However, the ratio of Allstate's exposures in underserved communities to its total exposures is an intra-company ratio, not a market share. Indeed, the weight of the evidence indicates that Allstate's market share in underserved communities is 9%, while the industry average market share is just 1%.

In weighing the evidence, Mr. Schwartz's testimony regarding Allstate's service to underserved communities is not persuasive compared to the testimony of Allstate's witnesses on this issue.

C. Conclusion.

Accordingly, the ALJ finds that Allstate has demonstrated its superiority in service to underserved communities in four ways:

1) It is superior to the industry in the ratio of its exposures sold in underserved communities to its total exposures.

[50] Schwartz Prefiled 30:17-31:6. On cross-examination, Mr. Schwartz seemed not to comprehend the difference between "percentage of total earned exposure to underserved communities" and "market share in underserved communities." (RT 431-432.)

2) Its market share in underserved communities is superior to the industry average market share.

3) Of the ten largest automobile insurance carriers in California, Allstate's market share in underserved communities is approximately one standard deviation above the mean of the market share of the ten largest carriers.

4) Only one other of the large carriers has a higher percentage of its agents located in underserved communities.

The ALJ concludes that Allstate has met its burden of proof on this issue, and qualifies for a 1% increase to its efficiency standard, pursuant to California Code of Regulations, title 10, section 2644.27, subd. (f)(3)(B).[51]

VI. Allstate Qualifies for Variance No. 4 (Higher Return on Equity Due to Higher Investment in Underserved Communities).

A. Applicable Law.

California Code of Regulations, title 10, section 2644.27, subd. (f)(4), provides:

> The following are the valid bases for requesting a variance: ¶ (4) That the insurer should be allowed a higher or lower return on equity due to higher or lower financial investment in underserved communities, as defined in section 2646.6.

The parties disagree on the definition of "investment in underserved communities." Allstate contends that investments qualifying for this variance are those listed in the 2005 California Organized Investment Network ("COIN") report.[52] FTCR contends that qualifying investments must be in communities identified by U.S. Postal

[51] Per Exhibit 113, a 1% increase to Allstate's efficiency standard, by itself, will result in an indicated rate decrease of 18.1%. Together with a 2% increase to Allstate's return on equity under Variance 4, discussed below, the indicated rate decrease is 15.9%.

[52] Allstate Post-Hearing Brief 22:11-20, 24:14-25:8.

ZIP Codes previously approved by the Insurance Commissioner.[53] CDI offers the following interpretation:

> ... The COIN Report shows that Allstate Insurance Company (excluding Allstate Life Insurance Company) invested a total of $82.5 million in COIN qualifying investments in those years. To be included in the COIN report an investment must be a community development investment, generally in a low to moderate income (LMI) community in California (Exhibit 201).
>
> Unfortunately, the definition of an investment in an IIUC ["investment in underserved community"] under Cal. Code Regs. Title 10 Section 2644.27(f)(4) is different from the definition of an investment that qualifies under COIN. Specifically, to qualify as an IIUC an investment must be in an "underserved community" as defined in section 2646.6(c). To comply with that section, the investment must be located within one of the zip codes listed in the Commissioner's Report on Underserved Communities....
>
> Still, when the requirements for COIN Investments are compared with the requirements for a variance for IIUCs both share the concept of low-income communities and it seems reasonable to expect that there will be a significant overlap. Further, Allstate has shown that it compares favorably with other insurers by making relatively large investments in underserved communities....[54]

This conclusion is borne out by CDI's California Community Development Investments CIS-2007 Statistical Plan, which provides, in part, "COIN's mission is to provide leadership in increasing the level of insurance industry capital in safe and sound investments providing fair returns to investors and social benefits to underserved communities."[55]

It should be noted that, while California Code of Regulations, title 10, section 2646.6, was most recently amended, effective March 15, 2003, subsequently enacted Insurance Code sections 926.1 and 926.2 (Added by Stats.2006, c. 456 (A.B.925))

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[53] FTCR Post-Hearing Opening Brief 24:4-25:8.
[54] 12:3-24.
[55] Exhibit 201-2.

constitute a more expansive statement of the public policy encouraging insurance companies to invest in underserved communities and does not mention ZIP Codes. For example, see section 926.1, subd. (b):

> "Community Development Investment" means an investment where all or a portion of the investment has as its primary purpose community development for, or that directly benefits, California low-income or moderate-income individuals, families, or communities. "Community Development Investment" includes, but is not limited to, investments in California in the following:
>
> (1) Affordable housing, including multifamily rental and ownership housing, for low-income or moderate-income individuals or families.
>
> (2) Community facilities or community services providers (including providers of education, health, or social services) directly benefiting low-income or moderate-income individuals, families or communities.
>
> (3) Economic development that demonstrates benefits, including, but not limited to, job creation, retention or improvement, or provision of needed capital, to low-income, or moderate-income, individuals, families, or communities, including urban or rural communities, or businesses or nonprofit community service organizations that serve these communities.
>
> (4) Activities that revitalize or stabilize low-income or moderate-income communities.
>
> (5) Investments in or through California Organized Investment Network (COIN)-certified Community Development Financial Institutions (CDFIs) and investments made pursuant to the requirements of federal, state, or local community development investment programs or community development investment tax incentive programs, if these investments directly benefit low-income, or moderate-income, individuals, families, and communities and are consistent with this article.
>
> (6) Community Development Infrastructure Investments.
>
> (7) Investments in a commercial property or properties located in low-income or moderate-income geographical areas and are consistent with this article.

FTCR's criticism of specific Allstate investments for being outside approved ZIP Codes is unfounded. For example, FTCR argued that "CA MGT Villa Vasona 96," in Santa Clara County, was not a qualifying investment because of its ZIP Code.[56] However, the COIN Report describes this investment to be for "Affordable LMI Rental Housing," which is included in the subsequently enacted Insurance Code section 926.12, subdivision (b)(1).[57] A second example suggested by FTCR to support this contention did not even relate to an Allstate Insurance Company investment, at it was an investment by Allstate Life Insurance Co. Since life insurance carriers' investments were excluded from the list Allstate compiled to demonstrate the level of its investment, compared to the investment by other non-life insurance companies, this second example is irrelevant.[58]

The parties also disagree as to the magnitude of Variance No. 4. Allstate requests a 2% increase to its return on equity, and FTCR argues that Allstate should get no increase. In its Post-Hearing Briefs, CDI withdrew its objections to Allstate's qualification for Variance No. 4, but still contested the amount of the variance requested by Allstate. CDI contends that Allstate's proposed variance computation is arbitrary, and CDI proposed an alternate method for calculating the variance amount.[59]

CDI offered no evidence on Variance Request No. 4 in these proceedings. However, CDI asserts, "COIN categorizes qualifying investments as having either 'high

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[56] FTCR Post-Hearing Opening Brief 24:22-25:5; Allstate Post-Hearing Reply Brief 17:16-17.RT 228-231.
[57] Exhibit 28-4.
[58] RT 231-244, 587:2-25. It is a commonplace that the investment strategies of life insurance companies are different from the investment strategies of property/casualty insurance companies: "The key distinction between life insurance and property and casualty insurance lies in the difficulty of projecting whether or not a policyholder will be paid off and how much the payment will be... The amount and timing of claims on property and casualty insurance companies are more difficult to predict because of the randomness of natural catastrophes and the unpredictability of court awards in liability cases. This uncertainty about the timing and amount of cash outlays to satisfy claims has an impact on the investment strategies of the funds of property and casualty insurance companies compared to life insurance companies. (Fabozzi, *et al.*, Foundations of Financial Markets and Institutions (3rd ed., 2002) p. 112.
[59] CDI Post-Hearing Opening Brief 11-17; CDI Post-Hearing Reply Brief 7-8.

impact,' "medium impact," or "limited impact."[60] Although CDI did not present any evidence as to how or why COIN places any investment in one of these categories, CDI argues that it "does not believe it is appropriate to give Allstate a variance for all of its COIN investments. However CDI would grant Allstate a variance benefit for its high impact COIN investments. Specifically, CDI would support a variance equal to a three percent annual return on Allstate's high impact COIN investments."[61] As there is no evidence in the record in support of this theory, CDI's methodology is more arbitrary than Allstate's, which is based on credible evidence and reasonable actuarial judgment. Therefore, CDI's proposed methodology is rejected. The ALJ concludes that "investments in underserved communities" that qualify for Variance No. 4 are those listed in the COIN Report.

Finally, as with Allstate's Variance Request No. 3(B), FTCR complains that granting Allstate's Variance Request No. 4 will result in additional premiums in the sum of $32 million per year.[62] Similar to Variance 3(B), the ALJ determines that the variance is intended solely to result in a modification of the regulatory formula's component for return on equity, and no "end result" test applies to Variance No. 4. Again, the end result test only applies, by its terms, to Variance Request No. 11, the so-called "constitutional" or "confiscation" variance. Cal. Code of Regs., tit. 10, §2644.27, subd. (f)(11).) Similarly, and since CDI did not present any evidence on this issue for the record in this case, CDI's contention in its post-hearing briefs that Allstate will "double dip" if it gets

[60] CDI Post-Hearing Opening Brief 15:23-16:5.
[61] CDI Post-Hearing Opening Brief 16:8-11.
[62] FTCR Post-Hearing Opening Brief 28:7-8; Schwartz Prefiled 38:19-20..

this variance for its automobile insurance premiums and for its homeowners insurance premiums must be rejected.[63]

B. Evidence on Variance No. 4.

Mr. Armstrong and Ms. Even testified that Allstate's investments in underserved communities were higher than those of any other California automobile insurance company for the period covered in the 2005 California Organized Investment Network ("COIN") report, *i.e.*, Allstate invested $82.5 million, or 23.1% of the $356.5 million invested in underserved communities in California by non-life insurance companies in 1997-2004.[64] Mr. Armstrong testified that he conducted two statistical analyses of Allstate's level of investment in underserved communities relative to other companies' investments and determined that, by one analysis, Allstate was approximately two standard deviations from the mean of insurance companies, excluding life insurance company investments and, by another analysis, Allstate was more than 5 standard deviations from the mean.[65]

In her testimony, Ms. Even discussed Allstate's ongoing commitment to make investments in underserved communities. For example, in addition to Allstate's superior quantity of investments, Ms. Even participated in founding, with two other insurers, the "Impact Community Capital" fund for making sound investments benefiting underserved communities. Further, Ms. Even personally served on the subcommittee that developed COIN's investment program.[66]

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[63] CDI Post-Hearing Opening Brief 14:9-22.
[64] RT 48:3-51:25, 190:21-191:19; Exhibits 28 and 107.
[65] RT 87. In context, two standard deviations from the mean includes 95.5 of the subject population, and four standard deviations includes 99.99 percent of the subject population. (RT 119.)
[66] Even Pre-filed 4:6-8; RT 198:11-199:1, 200:12.

Ms. Even testified that Allstate's 2007 submission to COIN includes a large number of municipal bond holdings which were not included in the 2004 filing. Regarding the 2007 COIN Report (apparently unreleased at the time of the hearing), Ms. Even state, "I expect it will show a significant increase in Allstate's commitment to underserved communities. In fact, I don't know how many of our investments will end up being accepted, but our filing was for $497 million in terms of investments made just in 2005 and 2006."[67] Given the enactment of Insurance Code section 926.1, it is reasonable to assume that more of Allstate's investments (such as qualifying municipal bonds) will be recognized as investments in underserved communities.

Ms. Even also testified that, while some of Allstate's investments had matured, Allstate had reinvested in similar types of vehicles and had made additional investments.[68] Further, as Allstate demonstrates that its investment record in underserved communities has been superior, *relative* to other non-life insurance companies, it is reasonable to assume that those other companies likewise have had investments that matured, over time.

In response, Mr. Schwartz testified that Allstate showed only 2.5% of the total insurance industry investment in underserved communities, while Allstate had a market share of approximately 9% of the California private passenger automobile insurance market.[69] Mr. Schwartz's comparison is not persuasive, since the total insurance market also includes life companies, which have very different investment strategies from property and casualty insurance companies like Allstate. Mr. Schwartz initially testified that three insurance carriers had better investment records in underserved communities

[67] Even Prefiled 3:14-24; RT 196-198.
[68] RT 222:3-13.
[69] Schwartz Pre-filed 35:25-36:23, Exhibit 20.

than Allstate; later, on cross-examination, he acknowledged that none of those carriers wrote any automobile insurance business in California at relevant times.[70]

Weighing the evidence, the ALJ finds that Allstate's witnesses were credible as to Allstate's qualification for Variance No. 4, and FTCR's witness was not.

C. Conclusion.

Allstate's request for a 2% increase to its return on equity is based on substantial, credible evidence. CDI does not oppose Allstate's qualification for the variance, and has proposed a methodology for awarding a lesser amount for the variance that has no basis in the regulations or in the record in this proceeding. FTCR has not demonstrated that Allstate's COIN-qualified investments should not be counted as investments in underserved communities. Nor has FTCR demonstrated that Allstate's COIN investments have decreased over time.[71]

The ALJ finds that Allstate has satisfied its burden of proof as to Variance Request No. 4 and qualifies for a 2% increase to its return on equity, pursuant to California Code of Regulations, title 10, section 2644.27, subd. (f)(4).[72]

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[70] RT 444:4-17,446:12-448:1, 559:20-11: "Q. The fact is that they don't write automobile insurance in this state, correct?

A. I don't believe the State Compensation Insurance Fund does. Travelers may or may—may or may not have during the time period. I don't know all the way going back over the entire time period.

Q. So, this morning, your testimony that Travelers had made a COIN investment that exceeded Allstate's, you made that testimony—you gave that testimony at a time when you didn't even know whether Travelers wrote automobile insurance in the state during the qualifying time period?

A. I didn't know that.

Q. And you also talked about State Farm Fire & Casualty Company this morning, did you not?

A. Yes.

Q. And they don't write automobile insurance in this state either, do they?

A. No.

[71] FTCR Post-Hearing Opening Brief 27:4-11.

[72] Per Exhibit 113, a 2% increase to Allstate's return on equity by itself, will result in an indicated rate decrease of 17.3%. Together with a 1% increase to Allstate's efficiency standard under Variance 3(B), discussed above, the indicated rate decrease is 15.9%.

VII. Allstate Does Not Qualify for Variance No. 10 (Modified Trend Formula Due to Change in Mix of Business).

A. Applicable Law.

California Code of Regulations, title 10, section 2644.27, subd. (f)(10)(A), provides:

> The following are the valid bases for requesting a variance: ¶(10) That the trend formula in section 2644.7 does not produce an actuarially sound result because ¶(A) There is a significant increase or decrease in the amount of business written or significant changes in the mix of business."

Although section 2644.7 mandates that trend factors shall be developed using the company's most recent twelve quarters of rolling calendar year data, Allstate requests this variance based on the most recent six quarters of data. Allstate contends that, over the past six quarters, its "mix of business has shifted in that the number of insureds purchasing high limits coverage has slowed. The trend line for high limits coverage which had been increasing historically, flattened and is now decreasing for bodily injury coverage and uninsured/underinsured motorist coverage."[73]

CDI did not present any testimony relating to this variance request and does not address the variance request in its post-hearing briefs, except to state that it does not object to Allstate's request.[74]

FTCR argues that there has been no significant change in the mix of Allstate's business, and Allstate has not established whether any recent change is a temporary phenomenon or a permanent shift.[75] Further, FTCR contends that Allstate has not demonstrated that the trend formula in California Code of Regulations, title 10, section

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[73] Allstate's Post-Hearing Brief 28:25-29:2, 29:12-30, 30:8-13.
[74] CDI Post-Hearing Reply Brief 1:20-22.
[75] FTCR Post-Hearing Opening Brief 29:20-27, 30:16-26; RT 456:21-459:7.

2644.7, does not produce an actuarially sound result.[76] FTCR points out that there will always be minor statistical changes in policy data from quarter to quarter, and even if the six-point trend line is not precisely the same as the twelve-point trend line, that does not establish the actuarial unsoundness of the twelve-point trend.[77]

B. Evidence on Variance No. 10.

Allstate's actuary, Mr. Armstrong, testified that the trend for twelve quarters shows a slight increase, but a trend line for six quarters is flat, indicating a slight decrease.[78]

Although Variance No. 10 is only available where the twelve-point trend required by section 2644.7, subdivision (a), produces an actuarially *unsound* result, no Allstate witness so testified. Allstate's expert consultant actuary, Mr. Miller, opined that it would be "inappropriate" to use the twelve-point trend, since recent data demonstrate that the increase in the average premium has slowed.[79] He stated only that Allstate's six-point trend would be "actuarially reasonable."[80]

While Allstate's witnesses asserted that the six-point trend is different from the twelve-point trend, neither Mr. Armstrong nor Mr. Miller demonstrated that the regulation's twelve-point trend does not produce "an actuarially sound result."

Mr. Schwartz testified that Allstate did not demonstrate a significant change in the mix of business, did not quantify the impact of the percent of exposures with high limits

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[76] FTCR Post-Hearing Opening Brief 30:27-31:5.
[77] FTCR Post-Hearing Reply Brief 2:24-3:16, 23:16-28. See California Code of Regulations, title 10, section 2644.7, subdivision (a): "Trend factors shall be based on the exponential curve of best fit. Premium and loss trend factors shall be developed using the insurer's company-specific *most recent twelve quarters* of rolling calendar year data excluding catastrophes...." (emphasis added)
[78] RT 54:11-55:5, 57:2-15; Exhibits 105 and 111.
[79] Miller Pre-filed 14:4-15, 30:7-11; RT 131: 10-22.
[80] Miller Prefiled 14:1-15.

on the observed premium trend, and did not show whether the recent change is a temporary phenomenon or permanent change.[81]

C. Conclusion.

A mere change in an insurer's premium trend, especially one that is only slight and possibly temporary, does not qualify for Variance No. 10. On this record, Allstate has not sustained its burden of proving by a preponderance of the evidence that the change in its premium trend is significant or that it is a sustained trend. The ALJ finds, therefore, that Allstate is not entitled to Variance No. 10.

VIII. Motions to Strike Allstate's Testimony in Support of Variance No. 11 (the "Constitutional" or "Confiscatory" Variance) Were Properly Granted.

Pursuant to a stipulation by the parties, Allstate reserved "its right to argue for Variance No. 11 on appeal only, but is not contending, and will not contend, that there is sufficient evidence remaining (after entry of orders striking testimony and exhibits) to support a Variance No. 11 finding. Allstate has not waived its right to argue that its Variance Request No. 11 should be granted and that the orders striking testimony relating thereto were erroneous."[82]

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[81] Schwartz Prefiled 40-41.

[82] Allstate's Post-Hearing Brief 31:7-11. See *Fireman's Fund Ins. Cos.* v. *Quackenbush* (1997) 52 Cal.App.4th 599, 606-607 ["Proposition 103 restricts the Commissioner to making his final decision 'solely on the basis of the record.' (Ins. Code § 1861.08.) The record is developed at the hearing, which the Commissioner does not conduct. (Ins. Code § 1861.08.) Were the Commissioner to rule on interim evidentiary rulings, he would in effect be participating in the conduct of the hearing and also conducting an unauthorized interim review.... The interplay of Proposition 103 and the APA requires the ALJ, not the Commissioner, to conduct rollback hearings and prepare a proposed decision, and the Commissioner to issue a final decision based on the record developed at the hearing, i.e., *after* the hearing is concluded. At most, the amendment to Government Code section 11512, subdivision (b), clarifies that the Commissioner is not bound by the evidentiary rulings made by the ALJ during the hearing, but in making the final decision may determine that certain evidence was erroneously admitted and so not factor it into his decision.[3] In other words, the Commissioner's review of the ALJ's evidentiary rulings takes place as part of the process by which he adopts, amends or rejects the ALJ's proposed decision." Footnote 3 adds, "Conversely, if the evidentiary ruling is one denying the admission of evidence, it is incumbent upon the proponent of the rejected evidence to make a sufficient offer of proof for the Commissioner's review, in the event the Commissioner concludes that the evidence is relevant to the final decision."].)

In light of Allstate's challenge of the ALJ's evidentiary rulings, the ALJ summarizes the bases of those rulings here.

California Code of Regulations, title 10, section 2644.27, subdivision (f)(11), provides:

> The following are the valid bases for requesting a variance: ¶(11) That the maximum permitted earned premium would be confiscatory as applied. This is the constitutionally mandated variance articulated in *20th Century* v. *Garamendi* (1994) 8 Cal.4th 216 which is an end result test applied to the enterprise as a whole. Use of this variance requires a hearing pursuant to 2646.4.

Allstate has the burden of proving every fact necessary to demonstrate that the regulatory formula's rate would be confiscatory. (Cal. Code of Regs, tit. 10, §2646.54; *20th Century Ins. Co.* v. *Garamendi*, supra, 8 Cal.4th at p. 292 ["'The burden of proving' otherwise 'rests on the party asserting the violation'.... It 'is not easily met.'"].) To prove confiscation in the rate proceeding, the insurer has the burden of demonstrating "severe financial hardship." (*Id.* at pp. 296, 324-325.) Further, proof of an "inability to operate successfully" is a "necessary—but not a sufficient—condition of confiscation."(*Id.* at p. 296.)

Irrelevant evidence is inadmissible (Evid. Code §§210, 350; Govt. Code §11513, subd. (c)), and the ALJ has discretion to exclude evidence if its probative value is outweighed by the probability that its admission will necessitate undue consumption of time. (Govt. Code §11513, subd. (f); Cal. Code of Regs, tit. 10, §2654.1, subd. (c); see Evid. Code §350; *Fireman's Fund Ins. Cos.* v. *Quackenbush*, *supra*, 52 Cal.App.4th at p. 605 ["The regulations governing rollback hearings promulgated under this statutory scheme state that, 'To the extent not otherwise specified by law or regulation, the [ALJ] shall: control the course of proceedings . . . Specifically, ALJ's 'shall admit evidence

[they find] relevant to the determination' of 'the minimum nonconfiscatory rate.' (Cal. Code Regs., tit. 10, § 2646.4, subd. (e).) The foregoing regulations are consistent with the authority granted the ALJ by the APA to rule on the admission and exclusion of evidence. (Gov. Code, § 11512, subd. (b)."].) Further, Allstate may not offer evidence for the purpose of relitigating a matter already determined by the regulations. (Cal. Code of Regs, tit. 10, §§2644. subd. (c).)

The ALJ's rulings on motions to strike Allstate's testimony found that essentially all of Allstate's prefiled and supplemental testimony in support of its variance request under California Code of Regulations, title 10, section 2644.27, subd. (f)(11), violated the ban on relitigating a matter already determined by the regulations (Cal. Code of Regs, tit. 10, §§2644. subd. (c).) and was irrelevant. (Evid. Code §§210, 350; Govt. Code §11513, subds. (c) and (f); Cal. Code of Regs, tit. 10, §2654.1, subd. (c).) For example, Allstate endeavored to substitute its own calculations in place of several of the components of the regulatory formula (*e.g.*, the Fama-French Three Factors multiple regression model should replace the regulatory formula's "rate of return" component[83]; Allstate's own internally developed leverage factor model should replace the regulatory formula's leverage factor component[84]; Allstate should use its own premium trend, instead of the one provided for in the regulatory formula[85]; the regulatory use of "surplus" and SAP should be replaced by "book value" or "market value" and GAAP[86]; the question of

[83] Prof. Cummins Prefiled, stricken by order filed August 7, 2007; Prof. Hamada Prefiled, stricken by order filed Sept. 12, 2007. Armstrong Supplemental Testimony 3:11-22; Haworth Supplemental Testimony 2:20-3:2. [Supplemental testimony by Armstrong and Haworth was filed on August 24, 2007, and stricken by the Final Rulings and Order on Motions by the California Department of Insurance and by the Foundation for Taxpayer and /Consumer Rights to Strike Portions of Allstate's Supplemental Testimony, filed September 19, 2007.]

[84] Armstrong Supplemental Testimony, 3:23-28; Haworth Supplemental Testimony 6:13-6:24.

[85] Armstrong Supplemental Testimony 5:14-6:7.

[86] Haworth Supplemental Testimony 3:3-6:12.

"confiscation" should be determined line-by-line, rather than as an end-result test, applied to the enterprise as a whole, contrary to the regulations and judicial authority.[87])

Therefore, the testimony was stricken.[88]

FINDINGS OF FACT AND CONCLUSIONS OF LAW

1. All findings in this decision shall be considered to be either findings of fact or conclusions of law. They should be read in conjunction with the discussion above which explains the reasons for the determinations.

2. The hearing was full and fair and allowed the parties a reasonable opportunity to conduct discovery, present testimony and documentary evidence, cross examine witnesses and submit pre-hearing and post-hearing briefs on the disputed issues in this matter.

3. In a rate hearing, the Commissioner reviews Applicants' proposed rates and determines whether they are excessive, inadequate or unfairly discriminatory using the methodology set forth in California Code of Regulations., title 10, section 2642.1, et seq.

4. The amended version of the ratemaking regulations contained in California Code of Regulations., title 10, section 2642.1, et seq., effective April 1, 2007, applied in this proceeding.

5. Allstate bears the burden of proving by a preponderance of the evidence that the requested increase will not result in excessive, inadequate or unfairly discriminatory rates as defined in California Code of Regulations, title 10, section 2644.1, *et seq*.

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[87] Haworth Supplemental Testimony 7:1-14:15.

[88] Order on Motions by CDI and FTCR to Strike Portions of Allstate's Testimony, etc., filed Aug. 7, 2007; Final Ruling and Order on Motions by CDI and FTCR to Strike Portions of Prof. Hamada's Testimony, filed Sept. 12, 2007; Final Rulings and Order on Motions by CDI and FTCR to Strike Portions of Allstate's Supplemental Testimony, etc., filed Sept. 19, 2007. See Order Denying Allstate's Motion for Certification of Questions to Insurance Commissioner, filed Oct. 23, 2007.

6. CDI's withdrawal of objections to Allstate's Variance Requests Nos. 3(B) and 10, and to Allstate's qualification for Variance No. 4, does not resolve those issues, and FTCR may continue to contest them.

7. The regulatory ratemaking formula, without variance, indicates a rate decrease of 19.4%.

8. Allstate's request for a variance under California Code of Regulations, title 10, section 2644.27, subdivision (f)(2), is not supported by the evidence in the record. Allstate did not satisfy its burden of proof that it had incurred additional costs for *bona fide* loss-prevention and loss-reduction activities or that Allstate had loss reductions commensurate with its increased expenditures

9. Allstate's request for a variance under California Code of Regulations, title 10, section 2644.27, subdivision (f)(3)(B), is supported by the evidence in the record. A 1% increase to its efficiency standard for demonstrably superior service to underserved communities is reasonable, on the following grounds:

a. Approximately 8.7 % of all industry exposures are sold in underserved communities, while Allstate sells approximately 9.4% of its total exposures in underserved communities;

b. The average market share in underserved communities is 1%, while Allstate's market share in underserved communities is 9%;

c. Of the ten largest automobile insurers in California, Allstate's 15.5% market share in underserved communities is approximately one standard deviation above the 10% mean of the market share of those ten largest companies; and,

d. Only one other large insurance carrier has a higher percentage of its agents located in underserved communities.

10. Allstate's request for a variance under California Code of Regulations, title 10, section 2644.27, subdivision (f)(4), is supported by the evidence in the record. A 2% increase to its return on equity for higher financial investment in underserved communities is reasonable, on the following grounds:

a. Allstate's investment in underserved communities for the period covered by the 2005 COIN report was higher than any other non-life insurance company;

b. Allstate invested approximately $82.5 million, or 23.1% of the $356.5 million invested in underserved communities in 1997-2004; and,

c. Allstate's level of investment in underserved communities was more than five standard deviations from the mean of insurance companies, excluding life insurance company investments.

11. Allstate's request for a variance under California Code of Regulations, title 10, section 2644.27, subdivision (f)(10), is not supported by the evidence in the record. Allstate failed to satisfy its burden of proof in establishing that the trend formula in section 2644.7 does not produce an actuarially sound result or that a short-term change in Allstate's mix of business was a trend.

12. On this record, the ALJ finds that a rate decrease of 15.9% is reasonable.

ORDER

Based on the foregoing, IT IS ORDERED that:

1. The requested decrease of 7.1% is rejected and

2. A 15.9% decrease is approved and shall become effective 20 days after the adoption of this decision by the Commissioner or as soon thereafter as Applicants are able to provide the necessary documentation to and implement the necessary changes with the California Department of Insurance Rate Filing Bureau.

This proposed decision is submitted on the basis of the entire record in this proceeding and I recommend its adoption as the decision of the Insurance Commissioner of the State of California.

Dated: February 13, 2008

CHRISTOPHER R. INAMA
Administrative Law Judge
Administrative Hearing Bureau